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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 1936

No. 4

FRANK M. McKEY, TRUSTEE IN BANKRUPTCY,
Petitioner,

vs.

MAURICE PARADISE, AS TRUSTEE,
Respondent.

No. 5

FRANK M. McKEY, TRUSTEE IN BANKRUPTCY,
Petitioner,

vs.

MAURICE PARADISE, AS TRUSTEE,
Respondent.

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENT.

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SUBJECT INDEX.

PAGE

Supplementary Statement of Facts 1

Position of Respondent 2

Summary of Argument and Authorities in Support Thereof 4

Argument 6

I. The relationship between the bankrupt and its employees was that of trustee and cestui que trustent 6

II. The moneys constituting the trust fund can be sufficiently identified 11

Conclusion 30

AUTHORITIES CITED.

Adams v. Champion, 294 U. S. 231 ..... 4, 13

Alexander v. Fidelity Trust Co., 249 F. 1 ..... 5, 13

Ballantine Law Dictionary (1930) p. 1303 ..... 4, 7

Bogert's The Law of Trusts and Trustees (1935) Sec. 1 ..... 4, 8

Canadian Bar Review, June 1934 Issue, pages 379 to 382 5, 17

Central National Bank v. Conn. Mutual Life Ins. Co., 104 U. S. 54 ..... 4, 12, 13

Duel v. Hollins, 241 U. S. 523 ..... 5, 27

Gorman v. Littlefield, 229 U. S. 19 ..... 5, 25

PAGE

Jennings v. United States Fidelity & Guaranty Company, 294 U. S. 216 ..... 4, 13

Knatchbull v. Hallet, 13 Ch. Div. 696 ..... 4, 12

Madras Official Assignee v. Krishnagi Bhat, 49 Times Law Reports, 432 ..... 5, 15

Mercantile Trust Co. v. St. Louis, etc. R. R., 99 F. 485 4

People, ex rel. Oscar Nelson, v. The Peoples State Bank of Maywood, 354 Ill. Sup. 519 ..... 4, 13

People, ex rel. Oscar Nelson, v. Peoples Bank and Trust Company, 353 Ill. 479 ..... 5, 23

Perry on Trusts and Trustees (7th Ed.) Vol. 1, Sec. 2 .... 4, 7

Peters v. Bain, 133 U. S. 670 ..... 5, 14

26 R. C. L. (1929) p. 1168 ..... 4, 7

Schuyler v. Littlefield, 232 U. S. 707 ..... 4, 13, 18

Schumacher v. Harriett, 52 F. (2d) 817 ..... 4, 13, 18

Southern Cotton Oil Co. v. Elliott, 218 F. 567 ..... 4, 6

Standard Oil Co. of Ky. v. Hawkins, 74 F. 397 ..... 5, 20

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BRIEF FOR RESPONDENT.

SUPPLEMENTARY STATEMENT OF FACTS.

To the statement of the case by petitioner, there should be a short supplement.

Subsequent to February 4, 1933, when the bankrupt commenced to withhold the moneys which it had undertaken to remit to the Employees' Welfare Association, the respondent, as the representative of the Association, requested of Leroy J. Williams, vice-president and general manager of the bankrupt, and M. D. Harrison, treasurer of the bankrupt, that the sums due the Association be paid. Payment, however, was never made. Later the respondent requested payment from the Equity Receivers and payment was refused.

With reference to the bank accounts of the Grigsby-Grunow Company, the practice of the bankrupt was to deposit all of its incoming revenue in its general bank account, from which it would from time to time withdraw moneys and establish various special accounts. The bankrupt was accustomed to withdraw from its general account or special accounts, as the convenience of the situation required, and the payroll was drawn from the various accounts, both general and special, indiscriminately.

The foregoing supplementary statement is undisputed between the parties and was stipulated to by them (R. 13).

Position of Respondent.

Respondent's theory of the case is that the accumulated deductions from the payroll of the bankrupt's employees, and which the bankrupt had failed to remit to the Employees' Welfare Association, constituted a trust fund in the hands of the bankrupt and that the trust fund can be sufficiently identified as part of the bankrupt's bank accounts.

Under respondent's theory of the case it is unnecessary to follow the somewhat elaborate classification of points

adopted by petitioner in his brief. Eliminating unnecessary and incidental theoretical minutiae, the instant case presents for the determination of the Court just two questions, namely: Was there a trust or fiduciary relationship between the bankrupt and its employees, and, assuming the existence of such a trust relationship, can the trust *res* or fund be sufficiently identified to allow the respondent to impress a preferential lien on the moneys in the bankrupt's bank accounts which came into the possession of the Trustee in Bankruptcy? Respondent insists that a trust relationship existed between the bankrupt and its employees and that the trust fund, under the facts stipulated between the parties, is clearly and sufficiently identified.

SUMMARY OF ARGUMENT AND AUTHORITIES IN SUPPORT THEREOF.

I.

The relationship between the bankrupt and its employees was that of trustee and cestui que trustent.

Southern Cotton Oil Co. v. *Elliott,* 218 F. 567;
Perry on Trusts and Trustees (7th Ed.) Vol. 1, Sec. 2;
Ballantine Law Dictionary (1930) p. 1303;
26 R. C. L. (1929) p. 1168;
Bogert's The Law of Trusts and Trustees (1935), Sec. 1.

II.

The moneys constituting the trust fund can be sufficiently identified.

Knatchbull v. *Hallet,* 13 Ch. Div. 696;
Central National Bank v. *Conn. Mutual Life Ins. Co.,* 104 U. S. 54;
Adams v. *Champion,* 294 U. S. 231;
Schumacher v. *Harriett,* 52 F. (2d) 817;
Schuyler v. *Littlefield,* 232 U. S. 707;
Jennings v. *United States Fidelity & Guaranty Company,* 294 U. S. 216;
People, ex rel. Oscar Nelson v. *The Peoples State Bank of Maywood,* 354 Ill. Sup. 519;
Mercantile Trust Co. v. *St. Louis, etc. R. R.,* 99 F. 485;

Alexander v. *Fidelity Trust Co.*, 249 F. 1;
Peters v. *Bain*, 133 U. S. 670;
Madras Official Assignee v. *Krishnagi Bhat*, 49 Times Law Reports 432;
Canadian Bar Review, June 1934 issue, pages 379 to 382;
Standard Oil Co. of Ky. v. *Hawkins*, 74 F. 397;
People, ex rel. Oscar Nelson v. *Peoples Bank and Trust Company*, 353 Ill. 479;
Gorman v. *Littlefield*, 229 U. S. 19;
Duel v. *Hollins*, 241 U. S. 523.

ARGUMENT.

I.

The relationship between the bankrupt and its employees was that of trustee and cestui que trustent.

The respondent predicates his right to a preferential lien against the bank accounts of the bankrupt, not in reliance upon any priorities provided for in the Bankruptcy Act, but on the theory that the bankrupt was holding the sum of $14,607.51 in the capacity of a trustee acting for the benefit of its employees.

It is undisputed law that a trustee in bankruptcy does not take title to any property which a bankrupt held as trustee and not individually. *Southern Cotton Oil Co.* v. *Elliott,* 218 F. 567. In this case the court held that where it appears that trust moneys have been mingled with the general funds of a depositor in a bank and the account has not in the interval been depleted below the sum comprising the trust fund, the final amount will be presumed to include the trust funds and title thereto in the hands of the trustee in bankruptcy is subject to the preferential lien of the beneficiary.

The petitioner does not quarrel and has not at any stage of the proceedings challenged respondent's statement of law that if the fund here in question be found to be a trust fund, that the Trustee in Bankruptcy did not acquire any title or interest therein. Indeed, all of the cases cited by petitioner proceed on the premise that if a trust fund is in existence and can be identified, the beneficiaries of the

trust are entitled to the full amount thereof from the fiduciary administering the particular insolvent estate in question.

The respondent contends that the relationship between the bankrupt, Grigsby-Grunow, Inc., and its employees was clearly that of trustee and *cestui que trustent*. A trust may be defined as "an obligation upon a person arising out of a confidence reposed in him to apply property faithfully and according to such confidence." Perry on Trusts and Trustees (7th Ed.) Vol. 1, Sec. 2; Ballantine Law Dictionary (1930) p. 1303; 26 R. C. L. (1929) p. 1168. In the instant case the bankrupt undertook the obligation of collecting the accumulated payroll deductions from its employees, segregating and remitting them promptly to the Majestic Employees Welfare Association. The entire plan, conceived and put into effect by the bankrupt, contemplated the welfare of the bankrupt's employees and their families by providing life, health and accident benefits for them. It should be remembered that the Majestic Employees Welfare Association was not only organized and maintained by the bankrupt, but that the bankrupt required all of its employees to participate in the plan and that it undertook through its facilities to make the requisite collections and to remit them to the Association. In order that the purposes of the Association could be consummated without an impairment of capital through unfortunate investments, it was stipulated that the funds of the Association should be, and as a matter of fact they were, invested solely in obligations of the United States Government. Here then is a situation where a large employer of labor initiates and puts into effect an insurance program for the benefit of its employees, in the course of which large sums of money accumulated from the wages and earnings of the employees are in the custody of the employer, who has

undertaken to transmit them to an agency set up by the employer to administer insurance benefits to the employees and their families. Beset by financial stringencies, the employer, in breach of its obligations, fails and neglects to remit the funds in accordance with its undertakings. As a result, when creditors close in and first Receivers in Equity and then the Trustee in Bankruptcy take over the assets of the concern, the employees find that their employer has been faithless to its trust and has comingled and confused their moneys with its own.

In Bogert's The Law of Trusts and Trustees (1935) Section 1, the author, in defining a trust, declares it to be "a fiduciary relationship in which one person holds a property interest, subject to an equitable obligation to keep or use that interest for the benefit of another * * *. A fiduciary relation is one in which the law demands an unusually high standard of ethics or moral conduct with reference to another * * *. *The ethics of ordinary business relations, where parties oppose each other at arm's length, do not apply to the trust.*"

The petitioner insists that the relationship between the employees and the employer was that of debtor and creditor; in other words, that they were dealing with each other at arm's length. In support of this, we submit, utterly untenable position, the petitioner assumes as a fact (petitioner's brief Point I) that the relationship of debtor and creditor existed at the inception of the transactions in question and that this relationship "persisted throughout." Petitioner's assumption is fallacious for the simple reason that *at the inception of the relationship there was no debt owing to the employees.* The right of the company to deduct the initiation and weekly dues was a condition of the contract of employment. The contract entered into

prior to the time the employee had any sum or sums due him, simply amounted to this: "We (the employer) will pay you so much compensation. If you stay with us for thirty days we will automatically, without consulting you or obtaining other or different consent or authorization than your acceptance of employment, deduct from your wages, membership dues for the Employees' Welfare Association. We maintain this Association in connection with our business and we require all of our permanent employees, that is, those who are employed for more than thirty days, to be members of this Association. In short, if you wish to work for us permanently, you must be a member of the Employees' Welfare Association. However, important advantages are conferred upon you by membership in the Association: you are assured of life, health and accident insurance benefits. After the thirty day period we will pay *you* so much and we will pay to *the Welfare Association,* for your use and benefit in terms of insurance protection, so much. To absolutely insure the safety of the funds, the Association will make investments only in obligations of the United States Government."

Having accepted employment under these terms, the employee was not entitled to receive the moneys deducted from his salary or wages. He had submitted to an arrangement whereby the bankrupt was to *use the deductions for his benefit by turning over the deductions to the Association maintained by the bankrupt.* To put it differently, legal title to the deductions was in the bankrupt, charged with the equitable obligation to apply the deductions in accordance with the terms of its undertaking to its employees. It is therefore clear that neither at the inception of the relationship between the parties, nor thereafter, was there a debtor-creditor relationship between the employer and the employees with reference to this fund.

The cases of *Susan M. Bayor* v. *American Trust & Savings Bank, Assignee,* 157 Ill. 62, *People* v. *Illiana State Bank,* 265 Ill. App. 29, and *Colegrove & Co. Bank* v. *Gaupp,* 357 Ill. 499, cited by petitioner involve facts utterly dissimilar from the case at bar. In each of these cases there was *originally a debtor-creditor relationship between the banks and their depositors or customers.* Unperformed promises to change this relationship were held insufficient to alter the status of the parties. In the instant case, not only did the contract of employment contemplate a trust relationship, but the fact is that up until February of 1933 the obligations arising from the relationship *were faithfully discharged.*

Respondent insists that the "ethics of ordinary business relations, where parties oppose each other at arm's length" do not apply here; that there existed here "an obligation upon a person arising out of a confidence reposed in him to apply the property faithfully and according to such confidence."

To view the relationship between the bankrupt and its employees as anything less than trustee and *cestui que trustent,* is, we submit, to completely ignore first, the confidential and fiduciary character of the relationship of an employer (and particularly a large employer) to its employees, second, the dependence upon the employer by the employee that the undertaking of the employer would be faithfully discharged, and third, the hopeless impossibility of the employees learning of, insisting upon and protecting their rights. To describe sums of money culled from employees at the instance, even more, upon the insistence and by direct act of the employer, to be used for the purpose of insurance benefits for them and their families, as a mere debt owing from the employer to the employees, and to

classify the claim of the employees with debts or accounts receivable incidental to ordinary commercial transactions, is, we urge, utterly contrary to every precept of the law of fiduciary obligation.

II.

The moneys constituting the trust fund can be sufficiently identified.

Assuming, as we feel this court will, that the relationship between the bankrupt and its employees was that of trustee and *cestui que trustent*, can the trust fund be sufficiently traced and identified so that a preferential lien can be allowed to the claimant? The history of this problem affords a pointed illustration of how courts over a period of time will whittle away at an enunciated rule of law which in its application leads to many unjust results, until the hardship of the rule is greatly minimized or entirely eliminated. Thus no more than a century and a half ago it was a settled legal proposition that moneys which had been confused or comingled by a fiduciary with other funds belonging to the fiduciary, could not be followed unless the claimant could specifically identify the money which belonged to him. This rule, which almost invariably tended to defeat recovery, was a natural incident of the more basic doctrine that in order for beneficiaries of a trust to follow a trust *res* they had to be able to identify it in specie. This situation naturally resulted in many decisions which seemed to defeat justice. The requirement that the claimant had to earmark or identify particular bills or coins before he could be permitted to recover, effectively cut off beneficiaries of trusts from recovering that which admittedly belonged to them, but which had been misappropriated or misused by unfaithful trustees or fiduciaries.

Finally, the earmark doctrine was distinctly discarded and repudiated in the leading case of *Knatchbull* v. *Hallet*, 13 Ch. Div. 696. There it was held, to quote the summary of the case by Mr. Justice Matthews in *Central National Bank* v. *Conn. Mutual Life Ins. Co.*, 104 U. S. 54, at pages 68 and 69, that:

> "If money held by a person in a fiduciary character, though not as trustee, has been paid by him to his account at his banker's, the person for whom he held the money can follow it and has a charge on the balance in the banker's hands although it was mixed with his own moneys. * * * The modern doctrine of equity as regards property disposed of by persons in a fiduciary position is that whether disposition of it be rightful or wrongful, the beneficial owner is entitled to the proceeds whatever be their form, provided only he can identify them. If they cannot be identified by reason of the trust money being mingled with that of the trustee, then the *cestui que trust* is entitled to a charge upon the new investment to the extent of the trust money traceable into it; that there is no distinction between an expressed trustee and an agent, or bailee, or collector of rents, or anybody else in a fiduciary position, and there is no difference between investments in the purchase of lands, chattels, or bonds, or loans or moneys deposited in a bank account. * * * Equity will follow * * * money even if put into a bag or indistinguishable mass, by taking out the same quantity, and the doctrine that money has no earmark must be taken as subject to the application of this rule. (Furthermore) the rule in Clayton's case (1 Mer. 572) attributing the first drawings out to the first payments in, does not apply; * * * the drawer must be taken to have drawn out his own money in preference to the trust money."

The doctrine announced by the *Hallet* case is now a well-settled law of general application. *Schumacher* v. *Harriett*, 52 F. (2d) 817; *Schuyler* v. *Littlefield*, 232 U. S. 707; *Central National Bank* v. *Conn. Mutual Life Ins. Co.*, 104 U. S. 54; *Jennings* v. *United States Fidelity & Guaranty Company*, 294 U. S. 216; *Adams* v. *Champion*, 294 U. S. 231; *People, ex rel. Oscar Nelson* v. *The Peoples State Bank of Maywood*, 354 Ill. Sup. 519.

In the case of *Mercantile Trust Co.* v. *St. Louis, etc. R. R.*, 99 F. 485, the court says:

> "It is now the settled doctrine that co-mingling a trust fund with the private funds of the trustee does not destroy the right of the *cestui que trust* to follow it; the co-mingling being wrong, the entire fund is impressed with the trust, and as long as an amount equal to the trust fund remains in the co-mingled mass, the same and all of it to the extent of the trust fund will be made to respond to the claim of the *cestui que trust*. The last-mentioned rule is in perfect correspondence with the rule first announced requiring the *cestui que trust* to show that his money or property is in the hands of a trustee; it simply enlarges the rule and allows recovery when and so far as the communal fund in which the trust fund has been inextricably confused is found in the hands of the trustee."

The case of *Alexander* v. *Fidelity Trust Co.*, 249 F. 1, again serves to illustrate the principle. In that case the court said, at Page 10:

> "The court's attention has not been called to any authority holding that, as against the *cestui que trust*, the trustee can set up his own failure to set apart

trust funds, and say: 'I converted your money to my own use long ago by mixing it with my own. True, I have ample to pay you, which is the product of the co-mingled funds, but I do not know which is yours and which is mine. You did not consent that I should do so, nor did you know that I did so, but by converting it to my own use I made you a mere creditor and the statute of limitations has run against your claim.'

"As found by the Master, the intent of the decedent to commingle the trust funds with his own was not one which the donor contemplated, nor the law sanctions, and cannot bind the *cestui que trust* without his consent or knowledge."

Another often cited authority in this connection is the case of *Peters* v. *Bain*, 133 U. S. 670. In this case, at page 693, the court approved the following statement of the rule:

"Formerly the equitable right of following misapplied money or other property into the hands of the parties receiving it depended upon the ability of identifying it, the equity attaching only to the very property misapplied. This right was first extended to the proceeds of the property, namely, to that which was procured in place of it by exchange, purchase, or sale. But if it became confused with other property of the same kind, so as not to be distinguishable without any fault on the part of the possessor, the equity was lost. Finally, however, it has been held as the better doctrine that confusion does not destroy the equity entirely, but converts it into a charge upon the entire mass, giving to the party injured by the unlawful diversion a priority of rights over the other creditors of the possessor."

In England, where the earmark doctrine of identification of a trust fund was formerly applied with utmost strictness, the greatest leniency is now shown on the question of identification if a fiduciary relationship has been established.

In the case of *Madras Official Assignee* v. *Krishnagi Bhat,* 49 Times Law Reports, 432 (1933), the claimant's father had 10,000 rubles "lying" to his credit with the firm of T. R. Tawker and Sons, with which the claimant's uncle was connected. The claimant's father directed that the uncle *invest* (italics ours) the money in the firm in the name of the claimant, who was then a minor, the money to be paid to the claimant upon attaining twenty-one years, and the interest in the meantime to be paid to the claimant's father. A receipt was given for the money, which described the fund as "a fixed deposit * * * carrying interest at 9% per annum." The firm encountered difficulties. A suit was instituted in the name of the claimant against the members of the firm, alleging that they were trustees of the fund; asked that they be removed and new trustees appointed in their place, with a direction to hand over the trust fund to the claimant. The defense admitted the trust but alleged that the suit was premature inasmuch as the claimant was still a minor and no breach of trust had been committed.

During the pendency of this case, Tawker and Sons was adjudged insolvent and the Official Assignee, in whom the estate of the insolvent firm was vested, filed a written statement putting the claimant to the proof of the existence and validity of the trust and denying that the claimant was entitled to any preferential claim.

Judgment was given for the claimant and was upheld on appeal in the Appellate Courts of India. On appeal to the

Judicial Committee of the Privy Council, the judgment was affirmed. The Judicial Committee considered "as the only possible question * * * whether the trust fund can be found in the assets of the trustee firm."

The court in its opinion, page 433, stated in part:

> "The trial Judge held on the evidence that the trust fund could be traced into the stock (of the defunct firm). The learned Judges of the Appeal Court were not satisfied that this was established, but they thought that the investment of the trust money in the general assets of the business was sufficient to give the respondent a charge upon the sale proceeds in the hands of the appellant, and in their Lordships' opinion the conclusion to which they came was right. * * *
>
> Assuming, then, that the whole assets of the business, including the 10,000 rubles as invested in it, passed into the hands of the appellant on the insolvency, their Lordships think that they so passed subject to any charge in favor of the respondent to which they may have been subject before the insolvency. * * *
>
> In the present case when once it was admitted that the 10,000 rubles were a trust in the hands of Tawker and Sons to be invested in their business and were so invested, the sum must be taken to have remained a part of the assets of that business and to have been there at the date of their insolvency, the beneficiaries being entitled at all times to a charge upon such assets in the hands of the firm. Upon the insolvency the assets passed to the appellant but passed subject to the charge."

In commenting on this decision, D. G. Farquharson, in the June 1934 issue of the Canadian Bar Review, pages 379 to 382, says in part:

"The recent decision of the Judicial Committee is an important and far reaching pronouncement on the rights of a *cestui que trust* in the following of trust funds, whether or not the same have become intermingled with and are indistinguishable from the property of the trustee, and whether or not the trust funds have been dealt with in accordance with the terms of the trust. * * *

It may be concluded that the view of the Judicial Committee is that, not only is it not necessary, in order to be entitled to a charge on the property passing into the hands of the trustees in bankruptcy, that the *cestui que trust* shall be able to follow the *res* of the trust fund into particular assets or a particular fund, but it is incumbent upon the trustee in bankruptcy, if he is to defeat the claim, to prove that the particular *res* of each trust, of which the bankrupt is trustee, has been lost or ceased to exist, *i. e.*, that it has not remained a part of the assets of that business and to have been there at the date of insolvency. This would be difficult, if not impossible, to show in many of our bankruptcies where there have been conversions and yet there remains in the business of the debtor goods, shares or money sufficient to compensate for the various conversions. Furthermore, an old judgment of Turner L. J. in *Pennell* v. *Deffell,* is approved as laying down the correct principle that as between the *cestui que trust* and a trustee or parties claiming under the trustee otherwise than by purchase for valuable consideration without notice, all property belonging to a trust, however much it may be changed

or altered in its nature or character and all the fruits of such property, whether in its original or its altered state, continues to be subject to or affected by the trust."

Under the broad rule laid down by the English court, the right of the claimant to recover here would be beyond dispute. While the United States courts have generally pursued a narrower view, it is a view that has been the subject of increasing liberality in application. *Schumacher* v. *Harriett,* 52 F. (2d) 817; *Schuyler* v. *Littlefield,* 232 U. S. 707.

In *Schumacher* v. *Harriett,* 52 F. (2d) 817, Harriett turned over to her bank two checks aggregating $9,193.02, which were in payment of life insurance on her deceased husband, with directions to invest $8,500.00 of the money in United States Government bonds. The officers of the bank agreed to do this and to credit her account for the amount of the checks above the $8,500.00 necessary to purchase the bonds. The bonds were never ordered and the checks, *without Mrs. Harriett's knowledge,* were credited to a savings account in her name. Six weeks later the bank was closed and taken over by a receiver. It appeared that the bank's balances at its correspondent banks were reduced until at the time of the bank's failure the account with one bank showed an overdraft and that with the other a small balance, which was applied by the correspondent bank on the indebtedness due from the closing bank.

The Trial Court entered a decree which held that the assets of the closed bank came into the hands of its receiver impressed with the trust in favor of Harriett, and directed that her claim of $8,500.00 be paid in full. The

receiver appealed, and in affirming the appeal the Circuit Court of Appeals, Fourth Circuit, said in part:

"The rule is well-settled that where property or funds which are the subject of a trust are used by a bank in such a way as merely to decrease its liabilities and not to augment its assets, no charge upon the assets arises in favor of the *cestui que trust* (citing cases). On the other hand, it is equally well-settled that where a bank, acting as trustee, mingles a trust fund with its other funds, the common fund resulting is impressed with a trust to the amount of the trust fund which has been so co-mingled and lost its identity; and in such case the *cestui que trust* is entitled to have the trust declared and the trust fund separated from the other funds, even though the bank, subsequently to the co-mingling, may have added to and made payments from the common fund, as the presumption is that it respected the trust and did not make payment from the trust property. A limitation upon the rule is that the amount for which the trust is declared may not exceed the smallest amount which the common fund contained subsequent to the co-mingling of the trust funds. * * * The (Harriett's) checks were received by the bank as cash and were treated by it as such. They increased the cash and cash items in the tills of the bank at the time. When it placed them to its credit in Richmond and New York banks it was dealing with them as its own, and the presumption is that cash which was left in its tills was intended to be subject to the trust. While it had, of course, the right to collect the checks, it had no right to place their proceeds to its credit in other banks without holding an equivalent amount in cash in its own vaults to satisfy the trust which it had assumed towards plaintiff; and we

> must assume that it respected the trust, as 'equity imputes an intention to fulfill an obligation' * * * *There is no more reason* * * * *for refusing to declare a trust on the funds remaining than there would be to refuse to do so because the bank had paid out the identical currency which the* cestui que trust *had placed in its possession* * * *. It must be presumed that the intention was that the cash remaining in the vaults of the bank is to be substituted under the trust* * * *.* The duty of courts is to apply the principles of law and equity to the conditions of changing life, and we have no doubt that in view of modern banking practices, the modern but well-settled doctrine of tracing trust funds is applicable to the situation here disclosed."

In the argument below, the petitioner contended that *Schumacher* v. *Harriett, supra,* was overruled in effect by a later decision of this Court in the case of *Blakely* v. *Brinson,* 286 U. S. 254. Respondent insists that there is a vital distinction between the two cases. In *Blakely* v. *Brinson, supra,* the bank's customer *voluntarily* deposited the funds to be used in his account in the regular way. In *Schumacher* v. *Harriett* the understanding between the bank and its customer was that only so much of the proceeds of the checks which were not required in the purchase of the bonds was to be deposited in her account. In other words, a special fund was created out of the money to be used in the purchase of the bonds in the latter case, while in the former case the moneys to be so used were deposited to the credit of the purchaser.

The liberality with which the doctrine of identification is applied is also illustrated by the case of *Standard Oil Co. of Ky.* v. *Hawkins,* Circuit Court of Appeals (Seventh Circuit), 74 F. 397. In this case the complainant deposited

certain funds in a bank at a time when the officers knew it to be hopelessly insolvent. Some considerable time after the receiver appointed by the Controller of Currency had taken possession of the assets of the bank, the complainant filed a claim for the amount of the deposit as an unpreferred claim. In due time a dividend was declared and a check was tendered by the receiver to the complainant for its share. The complainant then consulted counsel, and learning for the first time it might have re-claimed its deposit as fraudulently received, declined the check and filed a bill to set aside its apparent election and to re-claim the amount of the deposit. *It appeared that although the actual funds deposited had been distributed, the other assets of the bank held by the receiver would more than suffice to repay the amount.*

In a carefully reasoned decision, it was held that the complainant should be allowed to re-claim the full amount of the deposit. On page 399 of the opinion and following, the court says:

> "The fund for the creditors was increased by the amount of the proceeds of the securities tortiously obtained from the appellant. This fund was distributed in dividends to the creditors, and, it would seem, about the time the appellant was advised of its right to pursue the proceeds of the securities, and declined to accept its proportionate share. The fact of such distribution is urged as a sufficient reason to deny the relief sought. It doubtless would have that effect if no assets yet remained. * * * however, * * * the receiver has in possession assets of the bank from which he will realize moneys largely in excess of the proceeds of the paper wrongfully obtained by the bank from the appellant, and which went to swell the fund distributed among the creditors. *In such case equity*

should compel restitution of that which has been diverted, and, being unable to lay hold of the specific moneys improperly received, will seek to make restitution out of the assets which remain. The receiver is a trustee holding these funds for distribution among the creditors of the bank according to their respective rights. He is an officer of the law. Equity will not permit a trustee to avail himself, as against a *cestui que trust,* of a mistake of law on the part of the latter, when it is possible to correct the error without injury to the trust estate. Here, it is true, the specific money of the appellant is no longer in the hands of the receiver. It has been distributed by him, in the proper discharge of his duty, among the creditors; but as the property of the appellant was erroneously, although through no fault of the receiver, appropriated to the benefit of the general creditors, there is no injustice in a restoration, if assets remain out of which indemnification can be had. The general creditor will receive not a penny less than is his due. The appellant, if the remaining assets prove sufficient and availing, will receive that to which it is entitled, and no more. There has been an erroneous diversion of the fund,—caused, it is true, by the act of the appellant. If legal injury has resulted from the act, the appellant cannot be afforded relief; but it has not so resulted, and the general creditor will, by the granting of relief to the appellant, be put in no worse plight than before the act. Restoration for diversion of funds, whether from design or through mere error, is not to be denied unless the diversion has occurred through the wrong or error of the party seeking restoration, and when, in the case of error, there has been wrought legal detriment to the opposing right.

This is certainly true with respect to trustees and officers of the law, who are not permitted to assert a mere mistake of law as an excuse for the denial of justice, and who are required to act as any high-minded man would act under the like circumstances."

"Here the receiver is an officer of the law, having the assets *in custodia legis*. He has no interest in the fund, save to see that it shall be distributed among those entitled to it according to the highest principles of honesty and equity. The assets of the bank received by him are, with respect to the question in hand, to be treated as an entirety. Those assets have been swelled by the property of the appellant wrongfully obtained by the bank, and which went into the possession of the receivers. That in the payment of dividends he has disbursed the actual money so received can make no difference, so long as assets remain out of which restitution can be made. The creditors have received that to which they were not entitled, and that which belonged to the appellant. If restitution be made out of the assets still remaining, the creditors will receive no less than that to which they were originally entitled, and the appellant will only receive that which was its due. To compass such a result is the highest equity, since otherwise the appellant will be deprived of its own, and the general creditors will receive that to which they have no right."

The courts of Illinois have adopted a liberal rule in connection with the trust fund cases. In the case of *People, ex rel. Oscar Nelson* v. *Peoples Bank and Trust Company,* 353 Ill. 479, the payee of a check placed it with a local bank for collection. The bank mailed a check directly to the drawee bank with directions to remit, but the drawee bank

instead of remitting the money, sent to the local bank its draft on another bank where the drawee bank had sufficient funds. The drawee bank closed its doors before the local bank was able to collect payment on the draft. The court held that the drawee bank was not directed to remit by draft but only to remit, and its action in sending the draft does not change its relation from that of agent to collect to that of debtor to the payee of the check, and the amount of the check must be regarded as collected and impressed with a trust. The court, on page 485 of its opinion, stated:

> "As to the third point * * * that of tracing the trust fund into the hands of the receiver, there appears to be no dissent among the cases. It is a conclusive presumption in equity that a trustee dissipates or spends his own funds first, before touching or encroaching upon the trust fund. From this it follows that if there was more than the amount of the trust fund on hand at the time the draft was drawn, and at all times thereafter until the closing of the bank, the trust fund must have been included with that which the receiver took over."

It should be noted in this case that there was no segregation of the trust fund and yet the court impressed all of the cash assets of the bank with a preferential lien in favor of the claimant.

An important Illinois case involving the following of a trust fund is *People, ex rel. Oscar Nelson* v. *The Peoples State Bank of Maywood, supra.* In this case the village treasurer, contrary to the state statute of Illinois, deposited with the bank a sum in excess of the indemnity furnished by the bank in the form of surety bonds. The question presented was whether the deposit of these funds which the village treasurer had made knowing that the

bond furnished by the bank was legally inadequate, and accepted by the bank knowing it had not complied with the provisions of the state statute, constituted a trust fund. A divided court held that since the funds were deposited in violation of law, the village was entitled to a preferential lien to the extent that it could trace the moneys in the hands of the bankrupt, and remanded the case for the introduction of evidence on the question of identification. The important point about this case is that the substance of the relationship of the village and bank was that of debtor and creditor and yet the wrongful acts committed resulted in a finding that the bank was a trustee *ex maleficio*.

The case of *Gorman* v. *Littlefield*, 229 U. S. 19, again illustrates the extreme liberality of the present rule with reference to tracing trust property. In this case Gorman, from time to time, gave the bankrupt orders for a certain stock, aggregating *two hundred fifty shares*, and paid for them in full. The books of the bankrupt showed that upon the receipt of each order there was purchased for the account of the plaintiff the number of shares ordered, and certificates therefor were delivered to the bankrupt. The bankrupt, unknown to Gorman, disposed of all of the certificates to various innocent parties. When the trustee took possession of the assets of the bankrupt, there were in the bankrupt estate certificates of the stock in question, endorsed in blank, for an aggregate of *three hundred fifty shares*. The certificates of stock purchased for the benefit of the plaintiff, together with those purchased for other clients, were placed without discrimination in the same tin box. It was customary to take certificates to make delivery from that box, indiscriminately, unless the certificate had been transferred to the name of the customer. As to the stock in the bankrupt estate, no claim had been filed with the trustee, although the time for filing claims had expired.

Both the District Court and the Circuit Court of Appeals held against the plaintiff. The Supreme Court, in reversing the lower courts, declared:

"It is unnecessary for a customer, where shares of stock of the same kind are in the hands of a broker, being held to satisfy his claims, to be able to put his finger upon the identical certificates of stock purchased for him. It is enough that the broker has shares of the same kind which are legally subject to the demand of the customer. And in this respect the trustee in bankruptcy is in the same position as the broker."

"It is said, however, that the shares in this particular case are not so identified as to come within the rule. But it does appear that at the time of bankruptcy, certificates were found in the bankrupt's possession in an amount greater than those which should have been on hand for this customer, and the significant fact is shown that no other customer claimed any right in those shares of stock. It was, as we have seen, the duty of the broker, if he sold the shares specifically purchased for the appellant, to buy others of like kind and to keep on hand, subject to the order of the customer, certificates sufficient for the legitimate demands upon him. If he did this, the identification of particular certificates is unimportant. Furthermore, it was the right and duty of the broker, if he sold the certificates, to use his own funds to keep the amount good, and this he could do without depleting his estate to the detriment of other creditors who had no property rights in the certificates held for particular customers. *No creditor could justly demand that the estate be augmented by a wrongful conversion of the property of another in this manner or the appli-*

cation to the general estate of property which never rightfully belonged to the bankrupt. (Italics ours.)

The ground upon which the Circuit Court of Appeals decided the case seems to have been that the certificates were not sufficiently identified, but as we have said, they were on hand to an amount claimed by the appellant and more, and were not claimed by any other customer. We think there should be no presumption that the stock was stolen or embezzled with intent to deprive the rightful owner of it, and when the unclaimed shares are found in the possession of the bankrupt it is only fair to accept the general presumption in favor of fair dealing and to decide, in the absence of countervailing proof, that the broker out of his funds has supplied the deficiency for the benefit of his customer, which he had a perfect right to do."

In the case of *Duel* v. *Hollins*, 241 U. S. 523, by a divided court it was held that where, prior to insolvency, a brokerage firm purchases for the account of several different customers shares of stock of the same corporation, and at the time it becomes bankrupt it has less than the number of shares in its possession necessary to make a complete distribution to the customers thereto entitled, the shares on hand will be pro rated equally among all of the customers who had purchased and paid for the shares in question.

These two stock brokerage cases deserve the careful consideration of the Court. Here it is perfectly plain that the exact stock to which the customers were entitled could not be identified. Indeed, in *Gorman* v. *Littlefield, supra,* the stock to which the customer was entitled had been disposed of and therefore beyond any doubt did not constitute a part of the assets which passed into the hands of

the trustee in bankruptcy. In the case of *Duel* v. *Hollins, supra,* it is too clear for argument that it was impossible to definitely trace and identify any of the shares of stock to which any one customer was entitled. In each of these cases there was hopeless comingling and, in fact, absolute disposition of the trust *res,* and yet the court permitted recovery.

In the *Gorman* case the court presumed an intention of the stock broker to replace the trust *res* by subsequent purchases of stock. In the *Duel* case the court presumed an intention to restore fractional interests.

The petitioner has cited a number of cases such as *Thompson* v. *Common School District,* 67 F. (2d) 284 (C. C. A. 9), *Edisto National Bank of Orangeburg* v. *Bryant,* 72 F. (2d) 917-919, *Santee Timber Corporation* v. *Elliott,* 70 F. (2d) 179-183, *Swan* v. *Childrens Home Society of West Virginia,* 67 F. (2d) 84-88, and others, to the effect that where there is no augmentation of the insolvent's assets there is not a sufficient identification of the trust fund to permit a claimant to recover a preferential lien against the assets of an insolvent estate.

That this is not a rule of universal application is illustrated by the stock brokerage cases of *Gorman* v. *Littlefield, supra,* and *Duel* v. *Hollins, supra.* Respondent vigorously contends that no stricter rule of identification should be applied to the instant case than to the stock brokerage cases. Certain it is that if the tests invoked in those cases are applied here there can be no doubt as to the respondent's right to a preferential lien. But to accept, for the purpose of argument, the petitioner's contention that the requirement of augmentation is uniformly applied in this type of case and that a mere shifting of credits or decreasing of liabilities does not constitute augmentation, the respondent

urges nevertheless that there is a sufficient showing of augmentation of the bankrupt's assets under the facts presented for the Court's consideration in the instant case.

To begin with, the Court is reminded that the shifting of credits by the bankrupt was part of its malfeasance. It had no right to shift credits. As was forcefully pointed out by the Circuit Court of Appeals in its opinion (R. 33):

> "Bankrupt's right to credit itself with the unpaid wages was dependent upon its payment of said sum to the Welfare Association."

The bankrupt was absolutely obligated to promptly pay over the accumulated deductions to the Association, not to set up an account in favor of the Association on its books. In doing so it converted the fund represented by these accumulated deductions just as surely as though it had taken the money piece by piece from the payroll of its employees and deposited it in its general treasury. As to the requirement of augmentation, the respondent does not contend that the shifting of credits augmented the bankrupt's assets. The contention is that in crediting itself with having paid the employees their wages and by *retaining* the moneys deducted from the employees' wages and salaries, it augmented its assets. Certainly it is beyond controversy that if the bankrupt had discharged its obligations and had paid the money, as it was duty bound to do, to the Welfare Association, there would have been $14,607.51 less in the bank accounts of the bankrupt which were taken over by the Trustee in Bankruptcy.

The petitioner under Point IV of his brief sharply excepts to the language in the opinion of the Circuit Court of Appeals to the effect that the accumulated deductions had been converted by the bankrupt. However, an examination of the authorities cited by the petitioner in support of his position indicates that he has confused the remedy

with the wrong, for he has cited a number of cases to the effect that an action of trover cannot be maintained except to recover specific property which has been converted. We need not elaborate on the point that this is not a trover suit and the respondent's rights to this fund and the nature of the bankrupt's conduct are not to be ascertained by the formal limitations of the action of trover. We heartily subscribe to the determination of the Circuit Court of Appeals that this fund was wrongfully appropriated and converted by the bankrupt.

CONCLUSION.

It is respectfully submitted that in the instant case the trust *res* is subject to sufficient identification to impress a trust on the moneys in the bankrupt's bank accounts to the extent of $14,607.51. As pointed out above, the moneys retained by the bankrupt represented payroll deductions. If it had not been for the arrangement that the accumulated deductions were to be turned over to the Association, the deductions would not have been made and the moneys would have been disbursed in due course as salaries and wages. Three points are conceded under the facts:

(1) That all incoming revenue of the bankrupt was deposited in its general account and that for convenience or other reasons, various moneys were occasionally checked out of the general account and deposited in various special accounts;

(2) That all the accounts of the bankrupt were subject to payroll, and payroll was, from time to time, made by drawing on any or all of the accounts;

(3) That at all times from February 4, 1933 up until the appointment of the equity receivers on November 24, 1933, there were sufficient moneys in the various bank accounts of the bankrupt to more than cover the amount claimed.

In view of these conceded facts, it is submitted that in the instant case there is no difficulty at all in ascertaining the mixed mass of which the trust funds constitute a part. If the moneys had been duly disbursed as part of payroll, the moneys would have been withdrawn from any one of or all of the combined accounts of the bankrupt. It is therefore entirely reasonable and logical to say that these trust moneys can be traced to and identified as part of the general accounts of the bankrupt. It is not necessary that the bankrupt have taken the moneys out of its general funds and then re-deposited them, so long as it can be said with certainty that the trust funds are a part of the banking accounts of the bankrupt.

For the court to deny the appellant's prayer to impress a trust on the bankrupt's bank account to the extent of the claim would be in effect to penalize the employees for the wrongful and tortious act of the bankrupt. It would, in effect, give to the creditors moneys to which they are not entitled and which in fairness, we submit, should be returned to those who placed their trust in their employer to use the moneys in order that they and their families might be safeguarded from misfortune which would deprive them of the capacity or opportunity to earn a livelihood. Not only does every consideration of equity and fair play favor the appellant but in addition it is clear that the creditors are not being deprived of anything to which they are rightfully entitled. The estate is augmented by the funds wrongfully appropriated and retained

by the bankrupt. The moneys are subject to sufficient identification as being part of the bankrupt's bank accounts. There is, therefore, no rule of law or equitable consideration which operates to deny the appellant the right to a preferential lien against the bank accounts of the bankrupt which passed into the possession of the Trustee in Bankruptcy.

It is respectfully urged that, for the reasons given, the judgment of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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